Role of Institutions in Economics

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ROLE OF INSTITUTIONS IN THE ECONOMICS

One of the most perplexing questions in social science is in regards to the causes of economic growth and development in different countries (Scott, 2013). Social scientists are still trying to explain why some countries are poorer than others. Further, they try to understand why some countries achieve economic growth and others stagnate. The question is what can be done to induce economic growth and therefore, improve the living standards of a society. However, it should be noted that institutions play a fundamental role in causing the economic growth and development of different countries.

Institutions are constraints which are devised by humans and shape human interaction. These are the rules of any society, and humans have to follow them in order to be part of the community. Institutions are supposed to be a major determinant of incentives. Therefore, it is expected that the latter should have a great effect on economic outcomes including growth, poverty and development. Institutions often differ among societies owing to the approaches to collective decision making used (Lewis, 2013). There are two of them that are typically used when making collective decisions: dictatorship and democracy. Secondly, they can differ due to the economic institutions available in that country. The latter include entry barriers and a set of contracts which are available to business people (Chang, 2011). Further, there could be a difference when some formal institutions perform their functions in a different way. For instance, sometimes, the distribution of political power lies with various individuals or social classes because in different societies, democracy is viewed in other ways.

Economic institutions are of particular importance to economic outcomes due to the presence and perfection of markets and the structure of property rights. Economic institutions are imperative since they have a great effect on the structure of incentives of an economic nature in society (Perkins et al., 2013). Without property rights, individuals lack the incentive to invest in human or physical capital or even adopt new technologies. Economic institutions help in the allocation of resources (Konzelmann, 2014). Further, economic institutions play a huge role in determining who will get the residual rights of control, revenues and profits. When markets are ignored or they go missing, as was the case in the Soviet Union for instance, resources are misallocated and gains from trade start to go missing (Boschma & Frenken, 2011). Societies which have economic institutions which encourage and facilitate efficient allocation of resources, factor accumulation and innovation will end up prospering as opposed to those that do not.

Central to political economy is the idea that institutions, and specifically economic ones, are endogenous (Pejovich, 2012). This means that they are determined by the society or at least a small part of it. Therefore, the question pertaining why some societies are poorer than others can also be answered by why some countries have worse economic institutions than others. However, there does not exist guarantee that all groups and individuals will have the same preference on a similar set of economic institutions. The reason is that different economic institutions will often result in different distribution of resources. There will usually be a conflict of interests among various individuals and groups over the selection of economic institutions (Spolaore & Wacziarg, 2012). They are chosen depending on the political power of the groups involved. Sometimes, the efficiency of one economic institution in comparison with another may play a huge role. However, most times, political power ends up being the ultimate arbiter. The group that has more political power is more likely to secure the economic institutions that it prefers.

The notion that political power is the determinant factor of economic institutions has often detrimental effects. This notion leads to conflicting interests in regards to the distribution of resources and, therefore, in regards to the economic institutions (Michalopoulos & Papaioannou, 2013). However, another question is why the groups which have conflicting interests usually do not agree on the economic institutions which maximize aggregate growth.

It is imperative to note that political power involves more than political institutions. A certain group of individuals may wield political power even without political institutions (Inglehart, 2015). These individuals can revolt, hire mercenaries, use economically costly but peaceful protests or co-opt with the military so as to impose their wishes on the society. This kind of political power is called de facto and it has two sources. The first one depends on the ability of the group in question to make sure that people act in unity even when some individuals may enjoy free rides. Secondly, the power of a de facto depends on the economic resources that the group can access. This determines the ability of the group to use the existing political institutions and the force that they can use against rival groups.

Further, political institutions are also endogenous though this is slowly changing. Often, societies will transition from dictatorships to democracies and change these institutions so as to modify the constraints of those who hold power (Oatley, 2012). The distribution of political power is a key determinant of the evolution. This usually creates a tendency for persistence whereby political institutions allocate de jure political power and will maintain political institutions which gave them the power. Sometimes, de facto political power will create changes in political institutions. These changes are often discontinuous. For instance, when an imbalance of power can possibly lead to a revolution or when the threat of an imminent revolution leads to ROLE OF INSTITUTIONS IN ECONOMICS 55reforms in political institutions. These aspects usually influence the manner in which political institutions function, for instance, whether rules laid down in an institutions are respected in functioning democracies or in democracies that have failed, the rules are ignored like in Zimbabwe today.

Economic institutions matter since they shape the incentives of the key actors of the economy. In particular, economic institutions influence investments both in human and physical capital, technology and the organization of production. It is important to note that geographical and cultural factors also matter in regards to economic performance, but differences in economic institutions are the greatest source of cross-country differences in regard to economic prosperity and growth. Economic institutions control the economic growth potential of the economy and other economic outcomes such as the distribution of resources in future. The latter include human capital, physical capital or wealth. In other words, not only do the economic institutions influence the size of the pie but also how it shall be divided among different individuals and groups in the society.

The Effect of Institutions

There are differences in regard to how the political and economic life is organized (Besley & Persson, 2011). There is a lot of literature that goes in depth into the differences of economic institutions across the countries. It shows a correlation between political institutions and economic performance. Different studies use various measures to look into the issue of institutions. Some of them have used the reinforcement of property rights, others have employed corruption or entry barriers. All these are indicators of economic performance and can be used to determine the economic climate of a country.

The Development of Property Rights in Europe in the Middle Ages

It is necessary to give examples so as to clarify on a few issues which may come up in the context of the story. There is no doubt that lacking property rights of the owners of land, proto-industrialists and merchants had a negative effect on economic growth during this period (Esping-Andersen, 2013). Since political institutions, the kings and various kinds of hereditary monarchies, were responsible for political power, these rights were usually given by the monarchs. However, in terms of economic growth, monarchs had every incentive to protect their own rights, but they typically did not enforce the property rights of other individuals within the country. They used their power to impose arbitrary taxation, expropriate producers, allocate the productive resources of society and renege on debts. The result of this is that economic institutions in the Middle Ages provide little investment in regard to land, human or physical capital and technology, and ultimately failed to foster the much needed economic growth (Mayer, 2012). These economic institutions also ensured that monarchs controlled a huge fraction of economic resources in the society, therefore, solidifying the political power and ensuring the existing political regime continued.

In the seventeenth century, major changes in the political and economic institutions paved way for the development of the rights of property and limited the power of the monarchs especially after the Civil War of 1642 (Dunleavy, 2014). In the Netherlands, this happened after the Dutch Revolution. England possessed a great amount of de facto political power until the 16thcentury thereby leaving aside civil wars which were related to royal succession. At the time, there did not exist any other social group which could amass enough de facto power to actually challenge the king. Changes in the land market of England and the expanded Atlantic trade in the 17thcenturies increased economic fortunes and eventually the de facto power held by merchants and land owners. These groups were diverse, but they contained essential elements which perceived themselves as having interests that conflicted with the king's ones. The English kings were more interested in predating against the members of the society so as to increase the incomes made from tax. The merchants and the gentry were more interested in strengthening the rights of property.

By the 17th century, the growing prosperity of the gentry and the merchants based both on local and international trade particularly the Atlantic one (Baylis et al., 2013). This enabled them to field military forces which were capable of ensuring that the king was defeated. This de facto power was able to overcome the Stuart monarchs as they were fighting the Glorious Revolution and the Civil War. This led to a change in political institutions which stripped the king of a lot of his previous powers in regards to policy. These changes affected the economic institutions therefore strengthening the property rights of both capital and land owners and spurred a great process of commercial and financial expansion. The consequence was economic growth which later culminated in the Industrial Revolution.

Political Institutions

Other than economic institutions, there are other kinds of institutions such as political ones (Hayek, 2012). They are responsible for placing a check on those that hold political power. For instance, this can be done through the creation of a balance of power in the society so they are particularly useful for proper economic situations. The result is that without checking political power, those with power are more likely to choose economic institutions which are only beneficial for them and in the long run will be detrimental to the society. Thus, the property rights of a wide selection of people will arise. Secondly, good economic institutions are likely to arise when political power is in the hands of a broad group with major investment opportunities. The reason for this is that when all other factors are constant, power holders will benefit themselves from property rights.

CONCLUSION

Institutions persist for a long time and have consequences that are unintended most of the time (Auerbach et al., 2013). Different choices reflect different outcomes in political institutions and distribution of political power. Understanding implies getting to know why different countries get stuck in political equilibria which result in negative economic situations (Gwartney et al., 2014). Solving the great problem of development involves getting the knowledge of the instruments that can be utilized to push the society from the current bad political equilibrium to a good one. For instance, for African countries, promoting accountability, democracy, and checks and balances will definitely lead to better economic institutions and policies.

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